Some Thoughts on Canada-United States Sectoral Free Trade

Michael Hart

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PREFACE

This study was prepared early in 1984 while I was on loan from the Department of External Affairs to the Institute for Research on Public Policy. It reflects further thought on one of the themes to emerge from public consideration of the government's 1983 trade policy publications, *A Review of Canadian Trade Policy* and *Canadian Trade Policy For the 1980s: A Discussion Paper*. I hope that this essay will expand on the authors' proposal that the government give serious consideration to the possibilities of entering into sectoral free trade arrangements with the United States.

Important conclusions that emerged from the government's review of its trade policies were: Canadian economic well-being continues to be crucially dependent on access to foreign markets; the United States market is by far the most important market to Canadian exporters, both now and in the future; the multilateral trading system has served Canada well and will continue to do so in the future; Canada's future trade performance requires greater emphasis in public policy on promoting international competitiveness; and, there is no need for a radical shift away from the trade policy pursued by successive governments since the end of the Second World War—but we could do more with that policy through multilateral and bilateral channels to preserve our stake in trade.

With these conclusions in mind, the government announced its

intentions in a press release from External Affairs dated 31 August 1983.

> We will pursue new initiatives within the existing trade policy framework . . . [including consideration of] the advantages and disadvantages of limited free trade arrangements with the USA . . . where Canadian producers . . . could significantly rationalize or improve their efficiency as a result of improved access to the USA market.

Canada thus undertook to explore the possibility of mutually advantageous trade liberalization, an undertaking which, in itself, is not a commitment to negotiations. However, this initiative could demonstrate the continuing validity of an open trading system and help to reverse the global protectionist trend.

This essay concentrates on the issues which need to be addressed to reach this objective. It stresses the basic complementarity of bilateral and multilateral approaches to trade liberalization. It seems only natural that Canadian authorities should be examining ways to improve access and reduce vulnerability in what is overwhelmingly and increasingly Canada's most important market. But this initiative should not be construed as meaning an exclusive emphasis on the United States or a dramatic change of direction. On the contrary, it marks a return to realism after the aborted and unrealistic effort embodied in the Third Option of the past decade. Indeed, it has been suggested that only by improving the market base in North America for Canadian manufacturers will Canada penetrate third markets and thus diversify its trading relationships.

The following pages outline the policy considerations which underlay the government's decision to study the merits of sectoral, bilateral trade liberalization and the issues which must be addressed before deciding to negotiate. They examine the multilateral and bilateral dimensions of Canadian trade policy in developing a stronger domestic economy and promoting a stable and open international trading environment. The study traces the history of earlier efforts to improve access to the US market and examines in detail factors affecting trade liberalization for three sectors: urban transportation equipment, petrochemicals, and traded computer services.

A number of colleagues have read various drafts of this essay and

made helpful suggestions. I must in particular mention Derek Burney, John Weekes, John Curtis, Frank Stone, Doug Waddell, and Sandy Moroz. I am grateful for their advice and support. The views expressed, however, remain my own and I take responsibility for any ideas that have gone awry. This essay has also been read by the staff of the Royal Commission on the Economic Union and Development Prospects for Canada (the Macdonald Commission) and has been considered at a number of research seminars which sought to wrestle with the difficult issue of Canada's future trade relations with the United States. Its arguments have benefited from the discipline of these discussions.

Michael Hart
November, 1984

THE AUTHOR

Michael Hart is an official in the public service of Canada. Under the auspices of the Institute for Research in Public Policy he has recently completed work for the Macdonald Commission on the constraints and opportunities flowing from the international trading system as they affect economic policy in Canada, an expanded version of which will soon be published by the Institute. Mr. Hart was one of the principal contributors to and editor of the government's 1983 trade policy publications, *A Review of Canadian Trade Policy* and *Trade Policy for the 1980s*. From 1974 to 1983, he worked for the Department of External Affairs where he held several posts including one with the Permanent Mission of Canada in Geneva. Prior to joining the public service, Mr. Hart taught European history at the Universities of Toronto and Prince Edward Island and at McMaster University.

Many of the arguments favouring freer trade may be satisfied, however, by entering, gradually, into bilateral agreements to resolve particular issues of the type presented by US restrictions of Canadian sales of urban mass transit equipment and US tariffs on Canadian exports of petro-chemicals. Free trade with the United States on such a limited, sectoral basis would not raise the more difficult issues posed by the full free-trade option and would be consistent with the gradual movement by successive Canadian governments towards freer trade. Proceeding on such a basis need not necessarily be limited to Canada and the United States, but could include other interested countries.

A Review of Canadian Trade Policy, p. 212

SOME THOUGHTS ON CANADA-UNITED STATES SECTORAL FREE TRADE

Announcing the results of the government's comprehensive review of Canada's trade policies on 31 August 1983, International Trade Minister Gerald Regan placed the greatest emphasis on the fact that the government would be launching a detailed assessment of the opportunities for increasing trade with the United States, including possible bilateral free-trade arrangements limited to a number of specific sectors. This theme was highlighted in the media reaction to the trade policy review. A positive reaction from senior US spokesmen, including Trade Representative William Brock, further stimulated interest in the concept of bilateral sectoral free trade.

An important step towards reducing trade restrictions between Canada and the United States was taken on 17 February 1984 when Regan and Brock launched a joint study of the possibilities for freer trade in four product areas: steel, farm equipment, urban mass transit equipment, and computer services. While the exchange of letters committed the two sides to no more than a joint study of the four product areas, it amounted to a strong signal to the business community that the two governments were taking the trade policy review proposals seriously and wished to demonstrate some tangible results. Meanwhile, independent study by the two governments of other product areas has continued. If the joint and independent studies are to lead to freer trade, however, they must be pursued to a specific

purpose, and broad public support for this kind of trade liberalization must be found. This paper seeks to make a contribution to this effort.

Some History

Canadian trade policy over the past century can be explained, to some extent, by Canadian attitudes towards the US market, set out in detail by events such as the abrogation of the Reciprocity Treaty in 1866, the National Policy of 1879, the free-trade election of 1911, the aborted free-trade agreement of 1947, the Third Option of the 1970s, the reports, in 1975, 1978, and 1982, of the Senate Standing Committe on Foreign Affairs advocating generalized free-trade arrangements with the United States, and the trade policy review of 1983.

Since the end of the Second World War, Canada and the United States have pursued largely multilateral foreign economic policies and conducted their own trade and economic relations within multilateral agreements and institutions. Yet the need to address issues bilaterally has never diminished, nor has the historic question of whether or not to seek closer formal economic integration. The proximity and size of the US market have always made access to it crucial for many Canadian industries. Early in Canada's history as a nation, the United States was the primary source of Canada's imports of manufactured goods and soon after the First World War it replaced Britain as Canada's leading market. In the years after World War II, the United States' place in the Canadian economy grew steadily in both trade and investment. This was not unexpected. The Canadian economy offered great development prospects and Canadian and American businessmen, with similar attitudes and approaches, found it easy to penetrate each other's markets. Detailed corporate links, already widespread by the 1920s, continued to be forged and the two countries became each other's best customers. They now have the world's largest bilateral economic relationship. Canadian trade policy assisted this process. Relatively high tariffs initially attracted US investment to serve the Canadian and British Commonwealth markets with US brands manufactured in Canada. As trade barriers were lowered, a certain amount of rationalization took place, while trade and investment continued to grow.

As the two economies became increasingly integrated, Canadians more and more frequently expressed concern about their country's ability to control the development of its own economy. Various policies were put in place in response to this concern. They aimed at encouraging greater Canadian control of the economy, diversifying Canada's trade and economic links, and ensuring that foreign investment was of net benefit to Canada. These policies were not always welcomed by the private sector on both sides of the border or by the US government. They seemed to tilt against natural forces and to frustrate the ability of business to maximize profits. In broad perspective, these different attitudes illustrate the tensions that have always dominated Canada-US economic relations.

Concurrent with the great growth in Canada-US economic interdependence since 1945, Canada and the United States pursued multilateral foreign economic policies. Post-war multilateral economic institutions founded under United States sponsorship, the General Agreement on Tariffs and Trade (GATT), the International Monetary Fund (IMF), the International Bank for Reconstruction and Development (IBRD), and the United Nations specialized agencies, provided a framework for such policies. Throughout the post-war years, the GATT has functioned as the basic trade agreement between Canada and the United States. In seven rounds of multilateral GATT negotiations, for example, the bilateral negotiations with the US have tended to be the most important and most productive for Canada. The 1983 trade policy review concluded that the multilateral trading system had served Canada well and assisted in managing Canada's relations with its most important trading partner.

But the trade policy review also strongly suggested that Canada consider entering into limited, bilateral, sectoral free-trade arrangements with the United States. At first glance, it appears that the main conclusion of the review and its most publicly discussed proposal are incompatible. A detailed examination of this issue should demonstrate that this need not be the case.

Objectives and Means

Neither preservation of the multilateral trading order nor pursuit of

bilateral arrangements with the US constitute *objectives* of Canadian trade policy. The broad objectives of Canadian trade policy were summarized in the trade policy review as:

> The development of a stronger, more efficient, productive, competitive, growing and non-inflationary domestic economy, the increased per capita wealth of which is shared by Canadians from all regions of the country; and
>
> The promotion of a more stable and open international trading environment within which competitive Canadian and foreign firms alike are encouraged to plan, invest and grow with confidence.
>
> *Canadian Trade Policy for the 1980s*, p. 1

Since the late 1940s, the multilateral trading order has proved to be the most effective *means* of achieving these objectives. Nevertheless, an important characteristic of Canadian trade policy in the post-war years has been its adaptability to changing circumstances. While "a gradual movement towards freer trade has been a consistent policy orientation of successive governments. . ." (*Canadian Trade Policy for the 1980s*, p. 9), various means have been used to achieve that end. We may recall that the post-war multilateral trading order was built on the foundation of a series of bilateral trade agreements negotiated by the United States, including two important agreements with Canada in 1935 and 1938. In addition, two bilateral deals with the US conditioned the productive growth of the defence and automotive industries in Canada (the Defence Production Sharing Arrangements dating from 1941 and the Automotive Products Trade Agreement of 1965). In other words, one should not confuse objectives and the means used to achieve them. Objectives are likely to remain fairly constant, available means vary with the times.

In the context of Canada-US trade relations, it is important to have a clear understanding of the terms multilateralism and bilateralism. Since the late 1940s, Canada and the United States have fostered first the establishment and then the preservation of a stable and strong multilateral trading order. Within that order, each has forged beneficial relationships with a range of individual trading partners and particularly with each other. The rights and obligations contained in multilateral and bilateral agreements are not mutually exclusive but rather complementary and mutually reinforcing. When

addressing issues between them, governments may involve bilateral or multilateral commitments or both. For most relationships there exists a continuum of bilateral and multilateral rights and obligations which reinforce each other and at times provide alternative approaches to issues. Yet, commentators have frequently suggested a need to choose between a bilateral or a multilateral approach to Canada's relationship with the United States, arguing that the two approaches are mutually exclusive. This is to insist on a false dichotomy and likely to give rise to poor policy options.

The Multilateral Approach

Seven rounds of multilateral trade negotiations GATT auspices have resulted in an unprecedented degree of trade liberalization, and future rounds may lead to further liberalization. The questions now are: Can this pace be maintained? Does the multilateral route provide the only basis for further trade liberalization? Will this multilateral approach provide realistic opportunities in the near future? How does one stimulate further rounds? Are there alternative options? Should Canada pursue opportunities to liberalize trade along multilateral lines, along bilateral lines, or even along plurilateral lines?

Multilateral trade negotiations under the GATT have changed significantly over the years, adjusting to circumstances, particularly increasing and changing membership. The first round of negotiations in 1947 involved 23 countries. They were dominated by the United States but included negotiations among a group of relatively equal trading partners. Only a few developing countries were represented. Japan and Germany were not members. Britain, France, Belgium, and the Netherlands were war-torn and rebuilding their economies. The next few rounds were similar; they concentrated on tariff cutting, largely through a series of bilateral negotiations within a multilateral framework. The Review Session and subsequent Tariff Conference in Geneva in 1955-56 could be considered the last in this series, although by that time Germany (in 1951) and Japan (in 1955) had acceded to the General Agreement.

By the time of the Dillon (1961-62) and Kennedy Rounds (1964-67), Europe had rebuilt, and the European Communities (EC) of the Six

were negotiating as one. US dominance had begun to wane. Developing countries had become prominent participants. This process was completed by the Tokyo Round, in which some 100 countries participated, beginning in 1973. The major players were the US, Japan, and the EC of the Nine. Tariffs were no longer the principal concern, and the problems of developing countries rose at every juncture. Trade liberalization in such circumstances is extremely complicated. Issues totally alien to the world of the late 1940s and early 1950s needed to be addressed. The Tokyo Round took six years to complete and severely tested the patience and creativity of all concerned. For some participants, the desire to repeat such an exercise remains low almost five years after its conclusion, although there appear to be tentative signs to the contrary. The GATT Ministerial Meeting of November 1982 reminded participants of the difficulty of achieving progress in the unwieldy forum which the GATT has become.

Changes in trading patterns and commercial policies since the 1940s and 1950s reflect not only the growth and evolution of the post-war system, but also of the new international division of labour. There are more players. There is an infinitely greater variety of products. Above all, the surge of technology has led to much greater and more rapid changes in comparative advantage than once characterized the world trading environment, and accelerated the international subdivision of labour, a process which should be of particular interest to countries with economic structures like that of Canada. There is now much more room for intercorporate cooperation through specialization. Canadian trade and industrial policy in the 1980s must be sensitive to this changing environment.

The need to maintain pressure for trade liberalization, however, remains acute. The clear lesson of past experience suggests that failure to pursue trade liberalization does not lead to maintenance of the status quo but, inevitably, to trade restriction. The past few years have shown that the forces of protectionism are always with us. Containing these forces requires ongoing trade liberalization initiatives. While the GATT will remain the major forum for trade liberalization, it can no longer be counted on as the only vehicle. Other avenues need to be explored. The so-called quadrilateral meetings among the trade

ministers of the US, Japan, the EC and Canada are one. Limited, sectoral arrangements may be another. None are exclusive. Each should complement and support the others.

If the GATT has become an unwieldy forum for trade negotiations, it has not become an impossible forum. Work now underway may bear fruit. Indeed, suggestions that work commence on a new general round have increased. Negotiations on greater coverage for the Agreement on Government Procurement now at an early stage, are of vital interest to Canadian industry. Similarly, work on barriers to resource upgrading may lead to more rational tariff structures in a number of markets.

On the same day that Gerald Regan and William Brock agreed on joint sectoral studies, they also agreed on supplementary procedures affecting safeguard actions by Canada and the United States. They signalled the need for some progress in the stalled Geneva safeguards discussions, and indicated a willingness to solve such problems bilaterally. Should such more limited efforts bear fruit, others may wish to join. The process of seeking liberalization may be as important as the result. Paramount is a process capable of yielding progress, even if it acts only as a "kickstart" for more broadly based negotiations.

The Bilateral Approach

The choice made in the trade policy review to consider bilateral arrangements with the United States was deliberate. It followed ten years of frustration in seeking improved access to Europe and, to a lesser extent, Japan. The arrangements forged with Europe and Japan as tangible expressions of the Third Option of the early 1970s have borne little edible fruit. They may produce in the future and remain valuable as bases for continued cooperation. They are not, however, an effective basis for early progress on trade liberalization and improved access to a larger market which would stimulate rationalization and productivity improvement for Canada's manufacturing sector. Failure to achieve a satisfactory deal for Canadian participation in the European A320 civil aircraft program is the latest in a long list of examples of dashed hopes. More than two-thirds of our manufactured exports go to the United States, and it is on the basis of a North

American economy that the private sector makes its growth plans. Impeded access to that market hampers modernization. Improved access can stimulate growth. Indeed, the US market is basic to export success in third markets. For this reason, the trade policy review suggested that future diversification of Canadian trade patterns depends on a sound North American base for many Canadian manufacturing companies. If they cannot compete in the United States and find customers south of the border, they will not find them in Europe, Japan, or the Third World.

There is a long history of effort by Canada and the United States to liberalize cross-border trade by lowering or removing tariffs and removing other obstacles to the free flow of goods. Between 1854 and 1866, by means of the Reciprocity Treaty, both countries removed all tariffs affecting raw materials. In 1911, a more comprehensive arrangement was proposed and then rejected by Canadians in the election of that year. In the early 1920s, despite growing protectionism, both countries removed tariffs on selected agricultural equipment in a move to help farmers. Bilateral trade agreements negotiated in 1935 and 1938 ushered in a broad exchange of most-favoured-nation treatment for the first time since 1866 and reduced tariffs on a range of products. In 1947-48 officials negotiated a secret free-trade agreement subsequently rejected by Prime Minister Mackenzie King. Special arrangements have existed since 1941 for the sharing of production of defence materiel and in 1965 the two countries entered into the Automotive Products Trade Agreement. Of these various efforts, the least known but most instructive in terms of today's circumstances, was the aborted trade agreement of 1947-48.

Recent evidence now suggests that these negotiations were much more extensive than generally known. King's diary for 6 May 1948, says, "I confess I get alarmed beyond measure at the casual way in which a few officials take it into their hands to try and settle the great national policies; force the hands of the Government, etc. without the least knowledge of the political side of matters of the kind or the least kind of political judgement."[1] He thus described his final reaction to detailed proposals for a Canada-United States free-trade agreement which had been worked out in great secrecy over a period of months

between two small groups of officials: John Deutsch and Hector MacKinnon prominent among them on the Canadian side and Clair Wilcox and Woodbury Willoughby on the US side.

His comments were somewhat unfair to Deutsch and MacKinnon and their colleagues. There had been close and continuous consultation with King and his cabinet but King at the last minute decided that the politics were wrong. Finance Minister Douglas Abbott and Trade and Commerce Minister C. D. Howe strongly favoured the treaty. To make sure that the idea could not be resuscitated at some later stage, the prime minister ordered all relevant papers destroyed, a feat possible before the age of the photocopier.

If adopted, the proposals would have resulted in a treaty by which Canada and the United States would gradually develop common trade and related policies with limited restrictions on cross-border trade. Tariffs would have been eliminated immediately, quotas over a period of five years, and the right to re-impose restrictions severely curtailed. While most of the documents were destroyed, some survived. One of these, a letter and memorandum from Deutsch to Herb Moran at External Affairs, is reproduced in Annex A.

King's decision to withdraw was made easier by the fact that the exchange crisis of 1947, which gave rise to the negotiations in the first place, had been largely resolved. The crisis arose because Canada, which traditionally paid for huge US imports through its exports to the sterling area, had found these exports threatened by Britain's perilous state, and thus needed to increase exports to the best prospect: the United States. Between 29 October 1947 and the end of March 1948, officials worked out an arrangement that would achieve this objective. While the results of the secret negotiations were not implemented, they played a positive role in pointing to solutions. Another factor instrumental in prompting Mr. King's decision was probably a purely coincidental press reaction. He made up his mind late in March. On 15 March 1948, *Life* magazine ran a rare full-page editorial entitled "Customs Union with Canada" and subtitled "Canada Needs Us and We Need Canada in a Violently Contracting World." The editorial claimed that Canada needs "complete and permanent economic union with the United States."

Canadian editorial reaction to the *Life* editorial was mixed but largely negative. The Ottawa *Citizen* saw *Life's* sentiment as "irreproachable," but its proposal as "too much even to oblige a friend" and "an inadequate reason for national suicide." The Toronto *Globe and Mail* saw "no observable economic advantage" for Canada, turning Canada "into a rich source of cheap raw materials for United States industry." The Saskatoon *Star-Phoenix* asked "who's against it, and why?" and answered: "We are against it. And the reason is that the time is past when economic union with the US would serve Canada's destiny." *New Liberty* magazine commissioned a nation-wide poll which demonstrated that 69 per cent of Canadians opposed economic union. *Maclean's* invited Queen's historian Arthur Lower to write an article on the pros and cons. Lower came down on the negative side.

While the overwhelming sentiment was negative, a number of editorialists were prepared to see some movement towards continental economic integration. The London *Free Press*, for example, opined that "Customs union would give neither the United States nor Canada anything that we can't get from a rational rearrangement of tariffs." The Montreal *Gazette* found it "hard to challenge the editorial's insistence that some degree of economic integration with the US is imperative to re-orient Canada's economic position internationally, with a maximum of assured, permanent advantage to Canada and a minimum of damage to Britain." The Vancouver *Sun* noted that "an economic tie-up with our nearest neighbour would be of tremendous advantage in both countries."

These more positive editorials were echoed in 1983 when the trade policy review papers were published, and again when Regan and Brock initiated their joint studies. The Halifax *Chronicle Herald* wrote: "Canada cannot afford to abdicate any avenues, in any direction of the world. But, at the same time, it cannot escape the fact that the American market is our biggest and our best, and it offers the brightest prospects for expansion." (2 September 1983). In a similar vein, on 10 September, the Winnipeg *Free Press* stated:

> It has taken more than a decade for the federal Liberal government to concede that the United States is and will remain the most important single export market on which most effort should be expended.

> . . . the Third Option. . . has been dead for most of the past ten years but the Department of External Affairs and the prime minister's office refused to issue a death certificate until now.

The Ottawa *Citizen* had also changed its mind. It editorialized on 7 September 1983 that "like it or not, Canada's economic fate is tied closely to that of the United States. The only question is, are we prepared to acknowledge this and use it to our advantage, or will we continue to mount a futile rearguard action against reality?"

Much had happened in the intervening 35 years. Canada's economy had grown, stimulated in part by increasing access to world markets, guaranteed by a multilateral trading system. Yet the attraction of the US market had not declined from a Canadian perspective. Impatience with finishing the job of free access to that market, begun multilaterally, spurred calls for more action bilaterally.

A further consideration is that US patience with its trading partners is wearing thin, as is the coalition of support for an open trading system. US legislators realize that the US market remains the most important market for most countries and that access to that market is worth something. Earlier US commitment to trade liberalization was as much motivated by political and strategic factors as by more narrowly defined trade and economic factors. The change in US attitudes occurs at a time when the importance of trade to the US economy (now some 12 per cent of GNP) has reached a point where many sectors depend on exports for their well-being or on imports to remain competitive. The United States is also running a substantial trade deficit which has led to an emotional debate in that country on the subject of industrial strategy. Many US businessmen, perceiving their access to foreign markets as less advantageous than that of their competitors to the US market, are lobbying for reciprocity and for conditional improvement in access. They are skeptical that the multilateral order will provide measurable reciprocity.

Canada is vulnerable to restrictive trade actions adopted by the United States, even when these are not directed at Canadian goods. Bilateral or more limited plurilateral liberalization, on the other hand, is perceived to provide measurable reciprocity. Canada cannot afford to let US frustration dictate future negotiations. The challenge is to

channel that frustration into creative directions, beneficial to the future growth of Canada-United States trade. Exploring limited sectoral arrangements is one of several possibilities. Such an approach also deflects attention from irritants: an objective shared by the two governments can provide a more positive, even confident, basis for government-to-government transactions.

Another element should be considered. A considerable body of opinion in Canada, as well as in the United States, favours much more extensive economic integration than any Canadian or US government has been prepared to contemplate. In Canada, this line of thought has been set out in considerable detail by the Senate Standing Committee on Foreign Affairs in three reports issued in 1976, 1978 and 1982. The federal government did not respond to these reports until the release of the documents published following the trade policy review in late 1983. This lack of interest suggested–unfortunately–that the reports were too far from the mainstream to warrant much attention. Whether one agrees with them or not, they represent a considerable effort by the Senate committee and respond to a widely held view in the Canadian business community. They were based on extensive public hearings. The government's current commitment to study the possibilities of sectoral free trade with the United States should be seen in part as a response to the Senate committee as it provides for a detailed examination of one approach that corresponds to its recommendations.

The three Senate reports echo the views of most businessmen and professional economists, although these groups reach similar conclusions for different reasons. Businessmen welcome any move to reduce artificial barriers to a market of 240 million and limit potential irritants in a relationship which is already largely integrated. Economists consider most barriers irrational and obstacles to efficiency gains. In its 1975 report, *Looking Outward*, The Economic Council of Canada ranked its support of Canada-United States free trade as the fifth among a number of strategies. Ahead of it were multilateral free trade, free trade with the United States, the EC and Japan, free trade with the US and the EC, and free trade with the US and Japan. Its emphasis on Canada-United States free trade followed the assessment that it was probably the most attainable.

That the business community remains vitally interested, if somewhat schizophrenic, on this issue is well demonstrated by two recent briefs to the Macdonald Commission. The Business Council on National Issues recommended serious consideration of complete free trade, while the Canadian Manufacturers Association cautioned against it, preferring a wholly multilateral approach. The government's limited move in the direction of sectoral free trade, has, in general, been greeted positively in Canada. More important, there have been few authoritative dissenting voices. These, including Peter Newman's critical February, 1984 article in *Maclean's* and an interview with Senator Pitfield in the 16 March 1984 *Globe and Mail*, are stimulating useful public debate.

Trade Liberalization and Deindustrialization

While rarely considered publicly in such terms, trade negotiations are largely about investment. Governments seek to improve access to foreign markets or protect their own markets with a view to influencing future investment decisions. With this in mind, what are the implications for Canada-United States trade negotiations?

There nas been increasing concern in Canada that trade liberalization is leading to the deindustrialization of Canada rather than fostering economic growth, and that government trade liberalization efforts are thus having a perverse effect. This argument has proved particularly attractive to those who oppose further integration of the Canadian economy with the US economy through bilateral trade liberalization (Professor Abraham Rotstein of the University of Toronto and others). Such commentators fear that without trade barriers to keep them here, many US companies will retrench their Canadian manufacturing operations and service the Canadian market from their US facilities. These are often the same commentators who bemoan the fact that Canada is largely a branch-plant economy and urge the government to pursue Canadianization policies more actively.

This much-debated policy problem can be resolved by a hard analysis of manufacturing in Canada and the role of trade policy in promoting manufacturing. Those who see a problem base themselves almost exclusively on the trade deficit in statistical categories which

describe exports and imports of manufactured end products. Since the Second World War, however, the Canadian economy has steadily diversified as the manufacturing sector has grown and become more competitive. Food and crude materials now constitute only about 30 per cent of our exports, while partially or fully manufactured products make up the other 70 per cent. Canada's comparative advantage remains in the resource sector with fully 60 per cent of exports resource-based at various stages of processing. Manufactured end products constitute the bulk of imports. These are not surprising features of the Canadian economy given its rich supply of resources, relatively small population, and wide geographical dispersion.[2]

The early growth of Canada's manufacturing sector was in large part a response to the tariff structure from 1879 to the early 1960s. It was built primarily with foreign investment to serve a domestic market protected by high tariffs resulting in the prevalence of branch plants. With the gradual reduction in tariffs, the rationale for many of these branch plants is disappearing. Canadian investment policy has further eroded this branch plant syndrome by encouraging foreign investment which results in exports and domestic sourcing. Trade liberalization has led and continues to lead to a rationalization and restructuring of the Canadian economy. Our trading partners are similarly adjusting to liberalization. While Canada must be sensitive to this adjustment process, Canadian industry must participate in it to remain competitive. Restructuring, however, is not to be confused with deindustrialization. The gradual growth in manufactured exports (whether fully or partially processed) demonstrates that restructuring towards more internationally competitive industries is of net benefit to Canada.

There is no question that trade liberalization affects corporate structures. The economic justification for branch plants to serve the Canadian market disappears. Restructuring these plants, for example, on the basis of a world-product mandate from corporate headquarters is already paying dividends and should continue to do so. Many competitive branch plants and Canadian-owned corporations providing a wide range of products for the domestic market are successfully making the transition to a narrower range of products for both the Canadian

and export markets. For example, lowering the Canadian tariff on fine paper to gain duty-free access to the US market has led to a more competitive and better structured fine-paper industry with expanded markets and opportunities. This adjustment was made without any loss of employment, a success story that can be repeated for other sectors. Security of access to the US market especially favours private sector decisions on corporate location.

The Economic Council of Canada has extensively researched this question and concluded that there is no problem. It stated in a recent report (1983, pp. 104-105):

> In sum, the manufacturing sector has not withered, and is not withering, in the face of increasing international competition. Moreover, while Canada is gaining in the exporting of fabricated materials but not in high-technology items, that is not to say that it is losing, relatively, in the latter. The upshot of all this is that Canada is a far cry from de-industrialization. In our considered judgment, there is no evidence of this process even beginning.

Trade liberalization is not the only factor affecting Canada's corporate structure and level of industrialization. Investment, fiscal, and monetary policies play a very large role in corporate decision-making. Some Canadian policy objectives in this area, such as those represented by the Foreign Investment Review Agency (FIRA) and the National Energy Program (NEP), have been much more instrumental in recent corporate decisions regarding location than has been the level of tariff protection or the effectiveness of our system of contingency protection. Any loss of industrialization due to these policies must be measured against the objectives set for them and benefits they attain.

The Nature of Free Trade

The notion of free trade needs some definition to be employed to any purpose. Historically, the idea essentially referred to tariff-free trade. This was understandable for an era during which the tariff constituted the principal device for regulating commerce. That era, however, no longer exists. While individual tariffs on selected products remain high (as high as 30 per cent) and can constitute a major deterrent to trade in the products affected, the tariff as such has become a less important or secondary factor, particularly in the Canada-US context. Tariffs that

remain are important in maintaining prices and incomes and some are particularly onerous in restricting access to further-processed products. At the end of the Tokyo Round it was calculated, based on 1976 trade patterns, that 80 per cent of Canadian exports to the US market would enter duty free by 1987 and a further 15 per cent at duties under 5 per cent. Equivalent US access was calculated to be somewhat lower (65 per cent free and 70 per cent under 5 per cent) due to the greater proportion of manufactured products in US exports. While these percentages will change as the product mix changes, the order of magnitude is significant. The scope for further tariff cuts is limited except for some specific sectors (textiles, clothing, footwear and petrochemicals), and except to facilitate further processing in some resource-based sectors.

Despite the general prevalence of low tariffs, however, trade is not free. Non-tariff barriers are now more prominent—particularly systems of so-called contingency protection, i.e., protection that is extended contingent on particular circumstances, such as dumping, subsidization, serious injury, etc. Any consideration of sectoral free-trade arrangements will need to concentrate on non-tariff barriers affecting access to promote "freer" trade.

Rodney Grey has been studying non-tariff barriers for many years. Since he left government service in 1979, he has written and spoken extensively of Canada's need to get inside the US regulatory system to improve the economic basis for a number of Canadian industries. Addressing an audience in Atlanta, Georgia in 1980, he said:

> You will observe that I have not referred to "free trade". By "free trade" the pundits mean the removal of tariffs. I hope it is accepted that trade is now regulated and made not free by a range of other and more important policy devices. We can deal with these, if we wish to, in such a way that some sectors of North American trade are freer. In this fashion we might evolve, piece by piece, policy by policy, a special trading regime or arrangement. But it would be a long way short of "free trade", but a good deal better than our present complex of arrangements.[3]

The government's 1983 proposals and the US response in the February 17 exchange of notes mark a cautious step in that direction.

US Attitudes

The positive attitude of the current US administration to the Canadian bilateral sectoral initiatives of 1983-84 has already been demonstrated by the actions of US Trade Representative Brock. His approach has been in part dictated by the administration's frustration with the trade policy of its other trading partners: the EC, Japan, and the Third World. On all these fronts, US commitment to the magic of the marketplace and thus to trade liberalization has met with little success. The United States considered the 1982 GATT Ministerial Meeting a highly qualified success at best. It is eager to be able to point to at least one area where there is some tangible evidence of movement towards freer trade.

In addition, US trade policy legislation specifically provides for the administration to negotiate bilateral deals with Canada. The 1974 Trade Act (which gave the administration negotiating authority for the Tokyo Round) authorized the president to negotiate trade agreements bilaterally and specifically with Canada, subject to congressional approval (Section 612). The 1979 Trade Agreements Act (which implemented the Tokyo Round) extends the president's 1974 authority to 1988 and provides for "fast-track" congressional approval, i.e., approval within time limits and not subject to amendment. While the authority is not specifically for tariffs, they can be included in the "harmonization, reduction, or elimination of any barriers to, or other distortion of, international trade." As events have shown, however, if negotiations proceed, it might be politically prudent to ensure congressional agreement.

The 1979 Trade Agreements Act called for the president to report on the possibility of entering into free-trade agreements with the countries of the "northern portion of the Western Hemisphere" (section 1104). The president's report, submitted in the late summer of 1981, was not supportive, despite candidate Reagan's earlier call for a North American accord. It admitted that chances were best for an agreement between the United States and Canada alone, but noted that Canadian preference for maintaining safeguards to ensure certain levels of production and employment ran directly counter to US preference for letting market forces prevail. The administration's attitude in 1981 was

conditioned by its attitudes to the recently rejuvenated Trudeau government's desire to strengthen FIRA's mandate and further entrench the goals of the NEP in legislation. Nevertheless, it noted that there was scope for narrower objectives: the reduction of certain residual tariffs, liberalization in specific sectors, and the expansion of certain GATT non-tariff codes on a bilateral basis.

From the early 1970s until the early 1980s Canada-United States relations were generally cool. Changing comparative advantage and the decline of US dominance at a time of growing importance of trade to the US economy had a profound impact on the US view of its place in the world economy. In 1971, in an effort to deal with a serious balance-of-payments problem, President Nixon imposed a 10 per cent surcharge on all imports. For the first time, Canada was not exempted despite pleas from the Canadian government. This had a deep psychological impact on Canada, led to the Third Option, fuelled economic nationalism, and conditioned overall relations. However, trade in automotive and defence products was exempted from the Nixon measures. While the special relationship had ended, there existed a way to shield Canadian exporters from the effect of temporary US trade barriers.

The years 1982-84 have been marked by growing interest in improved bilateral trade and economic relations. The conditions which marked US reluctance to proceed have been much reduced and the attitudes of William Brock and Gerald Regan are in the ascendancy.

The 1983 Decision

It is against this background that Canadian and US officials are addressing the desirability of pursuing bilateral, limited, sectoral free-trade arrangements. Analytical work will be required on both sides of the border to inform a decision on whether or not to proceed to negotiations. The trade policy review did not take that decision; nor did the Brock-Regan exchange of letters. They suggested only that serious consideration be given to the potential for sectoral free trade. The trade policy review proposed a number of sectors: petrochemicals, urban mass transit, textiles and clothing, which from preliminary analysis appeared to be plausible candidates for further study. Other

sectors have since been suggested including specialty steel, forest products, non-ferrous metals, power-generating equipment, communications equipment and computer data. These sectors may prove attractive candidates. Brock and Regan have more recently identified four priority sectors: steel, urban mass transit equipment, farm machinery and traded computer services.

Following a more detailed examination, either Canadian or US officials or both may conclude that the obstacles to trade liberalization on a bilateral, sectoral basis are too formidable, and that sectoral bilateral negotiations would not be productive. Nonetheless, the study will achieve several objectives: a demonstration of continued interest and commitment to trade liberalization; a commitment to the management of Canada-United States trade relations through pursuit of a common goal; an informed decision regarding one approach to Canada-United States free trade, for which there exists considerable support in Canada; and finally, the development of up-to-date information and analysis for use in possible plurilateral or multilateral trade liberalization negotiations, discussions on which are proceeding in parallel with the consideration of Canada-United States sectoral free trade.

In 1983 the government concluded that it did not favour pursuing the option of a full free-trade agreement or a customs union. It noted that "the evidence to date of the need to proceed [toward free trade] was not convincing, nor does a call for free trade command broad support . . . It remains, however, an option which may garner broader support at some point in the future if changed circumstances lead to different attitudes" (Department of External Affairs, 1983a). Neither does this essay specifically consider the issues involved in proceeding to complete free trade. There is already considerable literature devoted to this subject.[4] Nevertheless, many of the issues are the same, whether one pursues sectoral, functional or complete free trade. It is possible that the debate on sectoral free trade will stimulate consideration of the more far-reaching issue. The current debate on the more limited option can thus be viewed as a preliminary indication of modern attitudes on this issue.

So much by way of background and perspective. What are the

issues that need to be addressed? What procedures are to be followed? What results can be expected? The second part of this paper will seek to establish an overview of these issues and suggest how they might properly be addressed.

The Importance of Being Prepared

First we must build a detailed and up-to-date profile of the sectors considered plausible candidates for negotiation. Some of this work was done during the last decade as part of the preparatory work for the Tokyo Round and in the context of the sector task forces whose recommendations were part of the background work for the industrial strategy debate of the late 1970s. It is now being brought up to date and analyzed from the perspective of Canada-United States trade liberalization, modernization, and rationalization. We need to know who owns the candidate industries on either side of the border; recent and anticipated investment patterns; the degree of vertical integration; on which side of the border corporate decisions are made; and the competitive strengths and weaknesses of the two industries. We will also need to develop a detailed trade profile of the two industries. Where do companies buy their raw materials and where do they sell their products and services? What is the trade in products in the next stage of processing? What are the barriers to that trade? Which barriers to trade are specific to the sectors under consideration and which are of a more general nature? The development of such sectoral profiles will be indispensable to providing a data base for proceeding to the analytical stage and for eventual informed decision making.

The analytical stage should determine whether there exists an economic basis for negotiation. It must establish whether trade is being impeded by specific trade barriers and the effect such impediments have on investment patterns. It will assess the effect of trade liberalization for specific products on trade flows and on investment patterns. In short, its goal is to judge the potential costs and consequences of trade liberalization on both sides of the border. If this analysis demonstrates that the benefits outweigh the costs for the industries on both sides of the border, and defines the parameters within which such a conclusion is valid, a basis for a decision on

negotiations and for consideration of the next set of issues will be set.

Building a Consensus

Throughout this preliminary stage, close consultation with interested parties will be essential. In the private sector, discussions with the companies producing goods as well as those providing input into that sector and using its products will be required. Close involvement by labour, segments of which believe that their jobs are threatened by integration, will be needed. Future negotiations will succeed only if there is an effective consensus within the industry affected. The organization of a private-sector task force devoted to developing consensus in a particular sector would probably be beneficial.

Similarly, provincial authorities must be involved. Their participation will be conditioned by the issues to be addressed and the techniques used (government procurement by the provinces, for example, would require very active involvement). The provincial role in trade negotiations has increased over the years, reflecting the fact that such negotiations have moved well beyond tariff matters and provincial awareness that industrial development programs and tax bases are directly affected by the access to foreign markets which companies doing business in their province enjoy. Thus, while the federal government remains responsible for international trade negotiations, ensuring a sound basis for such negotiations increasingly requires provincial involvement.

Three Sectors

1. Urban Transportation Equipment

The Canadian urban mass transit industry is innovative, export-oriented, and well positioned to benefit from improved access to foreign markets. It currently exports about three-quarters of its production (some $300 million annually). Among the successful companies and products are Urban Transit Development Corporation (UTDC, an Ontario crown corporation with a world-wide reputation for innovation and its light-rail car system), Hawker-Siddeley (now managed by UTDC and producing double-decker commuter rail cars), SPAR Aerospace (linear induction motors), Bombardier (subway cars),

Flyer and General Motors (buses and diesel engines), as well as the Toronto Transit Commission and the Montreal Urban Community Transportation Commission (both providing systems expertise). An increasing proportion of the industry is Canadian-owned and using Canadian-developed technology.

Exports are vital to the continued growth and development of this industry. Although long-term prospects are likely to be best in developing countries, it is essential that there be a sound market base in North America over the short-to medium-term to gain the presence needed for long-term success. The US market remains huge and the Canadian industry is better positioned to serve it than the more remote and protected European and Japanese markets. Canadian manufacturers nevertheless require improved access to the US market to further penetrate it and thus generate cash flow, continuous production, new product development, and fuller capital utilization.

Access to the US market is currently impeded by three types of barriers: high tariffs (some in the 18 per cent range), competitive long-term financing, and buy-America restrictions under the Surface Transportation Assistance Act (STAA). Because governments are the principal purchasers of this type of capital equipment, government purchasing policies and the ability to offer a competitive financing package are crucial. The battle endured by Bombardier after successfully bidding to sell subway cars to the New York Metropolitan Transit Authority demonstrated the kinds of problems the Canadian industry faces in meeting US and international competition. Bombardier went so far as to establish assembly facilities in the United States to qualify under the STAA, although this did not appear to be the most efficient way to run its business.

While the Canadian industry is competitive and outward-looking, it is not a complete industry capable of meeting the full range of Canadian domestic requirements. The transportation equipment industry as a whole exports about two-thirds or more of its production, while the same proportion of Canadian market requirements are supplied by imports. It is thus a sector well integrated into world markets. However, Canadian import duties (in the range of 15-20 per cent) and government purchasing policies add to the cost of imports.

Given import and export patterns in Canada, the long-term requirements of the Canadian market, and the competitive strength of the Canadian industry, it would appear sensible to open up the Canadian market further in exchange for improved access to foreign markets for Canadian manufacturers. Just such a strategy was pursued during the Tokyo Round multilateral trade negotiations. Canada was eager to add entities which purchase urban transportation equipment to the list of those subject to the new GATT Agreement on Government Procurement and to reduce further the tariff on this range of products. Some of our trading partners were not prepared to go this far and the Tokyo Round was unable to act on this opportunity.

The United States indicated during the Tokyo Round and later that it was prepared to go further. While both Canada and the United States would prefer to improve the international policy basis for trade in urban mass transit equipment multilaterally, a bilateral deal is better than no deal. This holds true for both US and Canadian manufacturers and users. For these reasons this sector was chosen as a candidate for further study possibly leading to bilateral negotiations.

A promising approach for this sector lies in a Canada-United States procurement agreement related to the multilateral Agreement on Government Procurement and open to others should they be interested. Rodney Grey has put it this way:

> One should keep in mind that the Tokyo Round procurement code is an arrangement which offers the benefits of better access to those countries which offer better access; . . . What Canadians need is the setting aside of barriers to our potential exports to [the US] procurement market. We do not need and should not ask for a procurement preference in [the US] market. However, if others decide never to contract in, the practical result would be a Canada-US preference area for this type of trade. Given the proliferation of a variety of discriminatory and preferential arrangements around the EEC, directed against American and Canadian exports, I don't have any high-minded moral objections to solving some trade problems bilaterally.[5]

2. Petrochemical Products

The Canadian petrochemical industry, like the urban mass transit equipment industry, is a modern, export-oriented industry whose further growth is hampered by export barriers. Currently, some 40 per cent of this industry's annual production of $4 billion is exported, while 30 per

cent of Canada's needs are imported. Given that 90 per cent of the industry's resource requirements are of domestic origin, it is an important transformer of domestic resources and a major contributor to the balance of payments. While the industry is well integrated with US petrochemical producers, significant elements are Canadian-owned.

The industry is divided into two major segments: an oil-based sector concentrated in Ontario and Quebec around Petrosar in Sarnia and Petromont in Montreal, and a gas-based sector built around Alberta Gas Ethylene in Joffre, Alberta. It is a technologically sophisticated industry, capital-intensive and an important component of the total industrial structure, since it supplies a range of other industries (plastics, textiles, paint, tires, wire and cable, automobiles, etc.).

In 1984, the Petrochemical Industry Task Force Report to the federal government noted that while its future growth would depend on markets all over the world, its most immediate and important prospects lay in the United States, due to the size, nature and proximity of that market. It recommended that:

> a concerted effort by industry and government be developed towards the reduction of trade barriers for petrochemical products with our major trading partners. In particular, efforts should focus on bilateral negotiations with the US, and the continued development of negotiations with Japan. (p. 29)

The US industry is large, competitive, diversified but mature, and is evolving towards concentration on specialty products, leaving room for Canadian suppliers of commodity chemicals. In the short term, however, the Canadian plant is plagued by global overcapacity. But the combination of global economic recovery and the phasing down of less competitive producers in the United States makes the opportunities for Canadian producers real and realizable. The Canadian industry can count on its strengths, particularly its domestic resource base, to remain competitive. Its position would be strengthened by improved access to its major market, the United States, which currently takes 70 per cent of Canada's petrochemical exports.

During the Tokyo Round, improved access to the US petrochemical market was an important goal for Canada, but one which was not achieved. Despite intense negotiations, it did not prove possible to strike the kind of multilateral deal both sides were

interested in. US tariffs remain in the 7.5-18 per cent range. Nevertheless, both Canada and the United States indicated their intent "... to enter into discussions, following the conclusion of the [multilateral trade negotiations] looking to the possibility of an arrangement for further liberalization and expansion of trade in petrochemicals between them on a mutually advantageous basis."[6] These discussions never materialized, in part due to changing priorities and major policy developments, such as the introduction of the NEP. The need to improve the trade policy regime in North America to benefit the Canadian petrochemical industry remains.

A variety of US interests could also be served by entering into discussions with Canada. The United States has become increasingly dependent on foreign energy and looks to Canada for supplies from time to time. Canadian resources are unable to satisfy US appetites for long, but Canada could supply US requirements in other ways. This country could become a more secure source of oil–and gas-based petrochemical products, reducing the US need to import energy from less secure sources. US interest in binding Canadian export taxes on gas and oil can be related to US agreement to bind import duties at similar levels. The US plastics tariff is lower (in the 3-7 per cent range) than the tariff on key resins (10-12.5 per cent) and upstream petrochemicals (up to 19 per cent) from which they are derived, in itself an incentive to Canadian plastics producers. The inclusion of plastics and similar downstream products would engage wider US interests which are now disadvantaged by the high tariffs on their raw materials.

A basis for negotiations leading to substantial rationalization existed in the late 1970s. The opportunities, however, did not materialize, only partially for reasons related to bilateral trade in petrochemicals. Work should now be directed to building a knowledge base and industry consensus for negotiations in the mid-1980s. The report of the task force is a major step in that direction. It will be important not to let the opportunity slip away again.

3. Traded Computer Services

A third area ripe for consideration and included in the sectors being studied by the US and Canadian governments is trade in computer services. The urban mass transit equipment and petrochemicals sectors

involve trade in goods, are subject to a fully articulated trade policy regime, and are covered by the GATT. Trade in computer services exhibits none of these attributes. It is new, subject to inexact rules (both domestic and international) and exemplifies a broader need for a better understanding of what is involved in, and what rules may be desirable for, trade in services in general.

Since the conclusion of the Tokyo Round, the US government has emphasized the need for a better understanding of trade in services and for the elaboration of a framework of international rules. Work is now underway in the GATT, the Organization for Economic Cooperation and Development and the United Nations Conference on Trade and Development to meet at least the first of these objectives. Canadian government and private sector bodies have shown mounting interest in understanding Canada's place in trade in services. A federal government task force concluded two years ago that Canada has a major interest in the export of certain services but that it is now a net importer of services. Canada thus has an interest in working with the United States in promoting multilateral and bilateral cooperation to develop a framework of rules for this trade.

A bilateral agreement to cover trade in computer services would be a first step in this direction. A detailed study and proposal were recently prepared by Rodney Grey (1984). It concluded that an agreement establishing a Canada-United States common market in traded computer services was in Canada's interest and could serve as a model agreement to which other countries could adhere if they wished. The agreement thus could act as a building block for multilateral consensus in favour of an open regime for an important component of trade in services.

The Issues

After the development of detailed sectoral profiles and the beginning of consensus building within the private sector, the stage of addressing a range of specific issues will be reached. These would include:

1. Objectives

What specific objectives will be addressed for any particular sector? Will they encompass broadly based freer trade in that sector, or be

limited to tariffs? Will liberalization be confined to a specific group of products or will it affect the whole range of products understood to make up the sector? Will it relate to specific trade barriers or involve commitments regarding investment, energy, or resources, for example?

2. Open-ended or preferential?

Will it be better to seek preferential access for US and Canadian companies to each other's markets or to proceed with negotiations which others may wish to join? Various models exist to provide guidance as to what is negotiable.

The 1965 Automotive Products Agreement provided an improved basis for trade and production of motor vehicles in North America. Canada did not seek preferred access to the US market, but US negotiators could not contemplate duty-free access for third country producers and opted for preferred duty-free access for Canadian manufacturers. Canada, on the other hand, provided conditional free access. Any manufacturer of motor vehicles in Canada prepared to meet the conditions of the auto pact can import motor vehicles and original equipment parts duty free from any source. In this sense, the auto pact closely resembles duty-remission schemes available in Canada for other sectors.

The Aircraft Agreement negotiated as part of the Tokyo Round provides a plurilateral example of sectoral free trade. While negotiated within the GATT, it is not of direct interest to all GATT members and attracted the signatures only of industrialized countries. Its benefits, however, are applied on a most-favoured nation basis.

The Agreement on Government Procurement, which also drew limited participation, is a good example of a conditional plurilateral agreement. Its benefits are available only to its signatories and not to other GATT members, somewhat eroding the GATT-MFN principle.

It will be necessary to determine for each sector which of these general approaches is preferable and then to examine appropriate techniques. Whatever route is adopted, it is important to recognize our goal from the start: a balanced arrangement of mutual benefit or special status in the US market at the expense of third countries. As a matter of policy, past Canadian and US governments have taken the view that trade liberalization should be trade-stimulating rather than

trade-restricting or trade-diverting. This probably remains the most sensible approach, but it is a matter which should be addressed.

3. Form or Technique

Various instruments may be adopted to achieve a bilateral, sectoral arrangement with the United States. These range from a formal treaty covering a particular sector to a supplementary agreement under the Agreement on Government Procurement. Important considerations in deciding this issue are the nature of US interests and the best way to ensure US commitment.

US decision making is much more complicated than the analogous process in Canada. While the administration negotiates agreements, it is Congress which ratifies treaties and regulates international commerce. For practical reasons, Congress delegates specific authority to the administration but ultimately determines whether that agreement will be given effect in domestic law. US negotiators can act with some confidence when pursuing a specific authority, but this confidence diminishes as the authority becomes more general.

In Canada, Parliament has delegated a fair amount of authority to ministers to negotiate international commercial agreements. Should any agreement require enabling legislation, the system of cabinet responsibility in a parliamentary system ensures that the views of ministers will accord with the governing party. Disagreement would lead to defeat of the government.

As we noted earlier, the US executive has a general authority to negotiate agreements lowering non-tariff barriers on a reciprocal basis; this authority includes tariff-cutting incidental to an agreement to lower barriers more generally. A short-term tariff-cutting authority residual to the authority extended for the Tokyo Round lapsed at the end of 1980. The administration's specific authority (section 1104 of the Trade Agreements Act, 1979) to negotiate trade agreements with Canada is subject to congressional approval which means that any successful bilateral negotiation would require assurance from Congress through its participation or specific direction to be ensured the security of enabling domestic legislation.

The most suitable technique varies depending on the sector. For example, because governments are the principal purchasers of mass

transit, power generating and transmission, and of communications equipment, a supplementary agreement to the Agreement on Government Procurement would appear to offer a promising route. Such an agreement would concentrate on the most pressing trade barrier—buy-national preferences—and address them within a previously agreed framework. It would also provide a credible context within which to engage provincial and state authorities. A tariff agreement is required for the petrochemical sector and a comprehensive, new type of agreement for computer services. Other techniques would apply to other sectors.

4. Role of States and Provinces

Consultations with provincial authorities essential to consensus building may extend to specific commitments on their part. In the case of government procurement, for example, buy-national or buy-local policies can constitute a formidable obstacle to trade, and commitments to reduce these preferences could be more valuable than additional undertakings by the two federal governments. Other non-tariff barriers such as subsidization or regulation of resource industries may require extensive provincial and/or state collaboration. The degree of provincial/state involvement considered desirable and the nature of commitments will have to be assessed case by case.

5. Barriers to be addressed

While it is generally true that tariffs are no longer the principal means of regulating trade among industrialized countries, they remain important for certain individual products inasmuch as they may encourage or discourage further processing of resource-based products or maintain prices or incomes. Tariffs are the principal impediment to freer trade for textiles and clothing, steel, farm equipment and petrochemicals and are among the barriers to be addressed for these sectors. For these sectors, upstream and downstream tariffs remain important considerations in investment decisions. In the petrochemical sector, for example, plastics, one of the principal downstream products of the industry, are subject to a lower duty in the United States than the semi-processed chemicals from which they are derived.

In addition to tariffs, non-tarriff barriers impede freer trade flows in all three sectors, ranging from buy-national provisions in

government procurement to government-regulated pricing. In the textiles and clothing sector, quotas are widespread for many third-country suppliers but are not a factor in cross-border trade. In this sector, tariffs largely regulate cross-border trade, and non-tariff barriers regulate trade by both Canada and the United States with most third countries.

Non-tariff barriers can be divided into two classes: constant and contingent. The first type includes regulations and provisions in force at all times, and their effects can be predicted with some precision. These would include standards, subsidies, licensing, government procurement regulations, etc. The second type of non-tariff barrier is applied only when certain conditions are met and is usually applied for a fixed period. Such barriers are much less predictable and can be quite disruptive. These would include anti-dumping and countervailing duties and emergency safeguard measures such as quotas, surcharges, increased tariffs and tariff quotas.

US legislators have also introduced the notion of fairness to the application of non-tariff barriers in terms of those applying to fair trade, i.e., on all trade, and those applying only to unfair, or politically intolerable trade. Canadian officials have found such terms too subjective to be of much value, but their frequent use in the United States and increased use by the Canadian private sector suggests that it will be important to take account of such concepts in any bilateral arrangements. While all kinds of barriers have come increasingly under firm multilateral rules, there remains scope for further commitments on a more limited basis.

The United States also tends to take a broad view of what constitutes a trade distorting measure; it is noted for its single-mindedness and reluctance to see merit in any policies not its own. In non-tariff negotiations, Canada risks having domestic policies on investment, regional development, performance requirements, energy etc. subject to even more detailed scrutiny. While perhaps irritating, this may prove necessary, and indeed helpful. It would be difficult to achieve harmony on such matters but sectoral negotiations should not be seen as so far reaching as to require harmonization. There is room for negotiation.

Analysis of trade in the sectors under consideration must yield an understanding of the effects of the various types of trade barriers and their susceptibility to reduction or control on a more limited basis.

6. Safeguards

Most international trade agreements contemplate escape from any or all of their provisions on a temporary basis as a result of unforeseen circumstances, and prescribe penalties for taking such safeguard action. Theoretically such measures are regressive and should not be permitted but in practice they have proved essential to gaining democratic societies' support for reducing barriers to international trade. Any Canada-United States arrangements will likely contain similar provisions. It will be important to ensure that they are sufficiently circumscribed to make resort to them rare and onerous.

7. Multilateral and other Bilateral Commitments

Both Canada and the United States are parties to bilateral and multilateral agreements and arrangements which could be affected by any sectoral, bilateral instruments. The parties will be obliged to assess the effects and decide whether and how to make necessary adjustments.

The most important of these commitments are in the GATT. It constitutes the basic trade agreement between Canada and the United States and provides a context for bilateral negotiations. Depending on the technique and form adopted, the effects of new agreements on our mutual GATT obligations will have to be considered. The GATT provides a number of avenues for reconciling bilateral commitments with its multilateral obligations. Article XXIV of the GATT provides a framework of rules by which contracting parties can come to bilateral agreement to circumvent its general principle of non-discrimination by entering into a customs union, a free-trade agreement, or an interim agreement leading to either. Historically, many agreements reported to the GATT under article XXIV have been of the interim variety. For example, Australia and New Zealand have done this; while trade is free in some sectors, other sectors, on an interim basis, remain subject to tariffs and other trade restrictions. The European Economic Community is an example of a customs union and the European Free Trade Assoication of a free-trade area. An agreement between the EC and EFTA is a further example of an interim agreement: trade in

industrial products is now free, but agricultural trade remains subject to restrictions.

The GATT also provides for waivers from any of its provisions upon agreement by two-thirds of the contracting parties. The European Coal and Steel Community was established on the basis of a waiver which allowed for free trade in that sector. Similarly, the United States received a waiver from its obligations in order to implement the Canada-United States autopact providing for free trade in automobiles and original parts and equipment. Canada was able to meet its obligations by allowing any manufacturer of automobiles established in Canada to import free of duty up to an amount equivalent in value to its sales in Canada.

Finally, it is possible to proceed with an arrangement which does not meet the requirements of article XXIV and without seeking a waiver by offering to compensate any third party capable of demonstrating it has been disadvantaged by any sectoral free-trade arrangement. In assessing any or all of these techniques, the parties will have to consider the advantages to be derived from any bilateral, sectoral arrangement against potential disadvantages. The GATT is a pragmatic instrument and, over the years, has proved flexible enough to accommodate the needs of its signatories.

Jake Warren, now vice-chairman of the Bank of Montreal and a former senior government official whose last assignment was as co-ordinator for trade negotiations during the Tokyo Round recently addressed the question of new bilateral arrangements in a multilateral world. He told an audience at the University of Western Ontario:

> While as an old GATT hand I hate to contemplate further erosion of the MFN principle, as a realist I must recognize how substantially its writ has already been narrowed. We do live in an imperfect world. And if eventual arrangements between the two countries were to fall somewhat short of what is contemplated under the relevant GATT articles, the situation would hardly be unique considering the many special trading arrangements around the world which have been elaborated with or without the endorsement of the Contracting Parties.[7]

8. Impact on third-country interests

While Canada and the United States are each other's most important trading partners, both countries trade with many other countries and

have economic interests all over the world. An important issue to be addressed, therefore, is the impact, if any, of bilateral trade liberalization on Canadian and US economic interests in third countries. While the overall objective should be trade-creating, bilateral agreements may limit opportunities in the North American market for third country suppliers and lead to retaliatory action. Warren addressed this concern in the same speech.

> It follows that third countries' interests should be kept closely in mind as the choice and structure of possible arrangements for sectoral free trade are determined. And such structures would be expected to vary from case to case. Conceptually, some sectors or subsectors might be found where tariff removal and restraint in the application of non-tariff and comparable measures could be extended to other trading partners, immediately, or over time, without serious consequences for either of the bilateral partners. In other cases, arrangements might take a conditional MFN or "open-ended" character. And some situations might suggest that formal exceptions should be sought from the normal rules of GATT. Indeed, compensation could be considered if the foreseen benefits significantly outweighed the estimated international costs.

9. Sovereignty

There is, finally, the matter of political will. After the technical issues have been addressed and considered, ministers will need to assess political risks and benefits before proceeding to negotiations. They will have to weigh the costs and benefits for Canada's further economic development, regional considerations, the implications for relations with other countries, and the prospects and means of reducing interprovincial barriers to trade. This detailed analysis will take place in the context of an assessment of sectors of interest to the United States, and the potential impact on Canada's sovereignty.

Much that has been written on the issue of sovereignty is polemical rather than analytical, indicating to what extent this subject elicits political judgements. A full and competent analysis of the more technical issues outlined above should inform such a judgement. It should not be driven by the politics of fear or the symptoms of mindless nationalism. Rather, it should be based on an assessment of the costs and opportunities. The mood today seems favourable to making such a judgement concerning sovereignty rationally and confidently.

Conclusions

These are some of the issues. The list is not exhaustive. Others may emerge as analytical work proceeds. These, however, are indicative of the work required before officials will be in a position to seek authority from ministers or to exchange detailed views with US officials. The trade policy review set the clock ticking. It is likely to tick for some time to come.

It was originally envisaged that preliminary work would be well under way by mid-1983. The trade policy review was to have been concluded in time for the GATT Ministerial Meeting in November, 1982. It was not completed until 1983, in itself demonstrating that, for issues of broad national significance, events move very slowly.

Since the publication of the results of the trade policy review, a new government has been elected in Ottawa and President Reagan was re-elected for a second term. Interest in Canada-United States trade liberalization, if anything, has probably increased. While a certain amount of analytical work was undertaken over the past year, much more needs to be done before either government can take a decision to commit itself to negotiations, either on a sectoral or broader basis. This slower time frame will provide further opportunity to flesh out details, hone arguments, and build consensus with the private sector. Should both governments decide to proceed, they will be governments with mandates stretching to 1988, thus providing a stable political environment for negotiations.

To a large extent, Canadian trade policy has been, and will continue to be, developed as a trade-off between the business objective of improved access to foreign markets, the economic need to promote efficiency and competitiveness, and the political need to provide protection for those Canadian industries considered important in terms of national or regional interests. Decisions on the design and use of particular policy instruments are much conditioned by factors external to Canada, particularly those flowing from the international trade and payments system.

An important area of choice open to the government will be to what extent it seeks to achieve its trade policy objectives through the multilateral framework or through bilateral agreements. In the current

multilateral order, it would seem to make most sense for Canada to pursue those objectives which can be realized multilaterally in that context. However, there may be certain other objectives which do not readily lend themselves to multilateral solutions and which the government may decide to pursue on the basis of a bilateral negotiating route.

Canadian well-being is substantially dependent on relations with the United States. There is significant scope for the reduction or removal of barriers to cross-border trade and for improving the management of bilateral issues in a variety of areas. Discord in Canada-United States relations can act as a significant constraint on Canadian policy making; mutual commitment to common goals can open substantial opportunities. The success of new efforts to liberalize bilateral trade and to improve the management of bilateral trade and economic relations should thus figure prominently in Canada's agenda for the future, alongside continuing efforts to strengthen the multilateral system.

To conclude and to repeat, the study of Canada-United States sectoral free trade is about trade liberalization. From a Canadian perspective, it attempts to examine ways and means to improve the economic base in North America for a number of important Canadian manufacturing sectors. It is not an attempt to seek continental economic integration or to subvert the overall multilateral basis of Canadian trade policy. Rather, it seeks to exploit a window of opportunity which has recently opened and which should shed light on potential benefits. It merits particular attention during the current relatively neutral climate in Canada-United States relations. Indeed, this initiative may have proved its worth by adding to the influences which ended an unproductive period of profound irritation.

ANNEX A

Ottawa, December 16, 1947.

H. O. Moran, Esq.,
Department of External Affairs,
New Post Office Building,
O T T A W A.

Dear Mr. Moran,

I enclose herewith a secret memorandum summarizing the conversation which Mr. McKinnon and I had with Mr. Homer Fox, of the United States Embassy, concerning a proposed further Canadian-United States Trade Agreement.

You will appreciate that this material is of a highly confidential nature.

Yours very truly,

J.J. Deutsch.

Enc.

SECRET

Ottawa, December 16, 1947.

MEMORANDUM TO H. O. MORAN:

At the end of October, Canadian officials explored informally with the United States officials the possibility of a further Trade Agreement with the United States. It was suggested that such a further agreement should carry the Geneva reductions a stage further, including the free listing of a considerable number of items. Such free listing was not possible at Geneva because of the limitation on the Administration's power under the existing Trade Agreements legislation. In order to expedite the exploration of this Canadian proposal, United States officials requested that we should indicate in a general way the nature of the concessions in the United States tariff which we are seeking. We undertook to give such indication.

It was arranged that Mr. Homer Fox should see Mr. McKinnon and myself on this matter. Mr. Fox came to see us early in November. At this meeting, we made an oral statement illustrating what we had in mind. It was carefully explained to Mr. Fox that our suggestions were entirely informal and unofficial. The suggestions were intended to be illustrative, and should not be taken as the complete or final proposal. Mr. Fox assured us that he would take the suggestions as being illustrative only. Mr. Fox took notes during the discussion, and we do not know what he has reported to the State Department. We have not asked him to tell us what he reported since the whole proceeding was deliberately informal. We do not want to be officially committed by anything which we gave by way of illustration.

We gave illustrations under the following broad headings:

Agriculture,
Fisheries,
Forest Products,
Base Metals,
Manufactures.

Under agriculture, we thought that Canada might ask for the following: free listing of cattle, seed potatoes, field seeds, eggs, live and dressed poultry, turnips, hay and straw. Under fisheries, we will probably ask for the free listing of all the other important fish. Under forest products, we thought Canada would see free listing of lumber, flooring, shingles, plywood and veneers. In the case of base metals, we thought Canada would ask for a further concession on aluminum and the free listing of the other base metals. In the case of manufactures, we gave only a few illustrations because this was an enormous field which would have to be carefully worked out in detail. However, we thought Canada would ask for the free listing of certain heavy chemicals and fertilizer materials, a selection of fine papers, millwork and selected building materials. We thought that we should also try to work out a reciprocal rating on primary iron and steel, and a reciprocal rating on many machinery items, including the possibility of free listing in certain categories of heavy machinery.

As you see, these suggestions are not exhaustive, nor even comprehensive. They are simply indications of the sort of thing we have in mind. We are anxious that these indications should not be given any official status. Obviously, if and when the negotiations begin, the negotiating group would have to obtain official instructions. What those instructions might be, particularly with respect to the general depth of the tariff cuts we should seek to obtain, we do not know at this time.

J.J. Deutsch.

NOTES

1. Quoted in Cuff and Granatstein (1977) who trace the history of the negotiations in considerable detail, relying heavily on US archival sources.

2. The structure of the Canadian economy is examined in *A Review of Canadian Trade Policy*, Department of External Affairs (1983b), pp. 19-27.

3. In a speech given on 4 February 1980 to a joint conference on trade and technology of the National Association of Manufacturers and the Canadian Manufacturers Association.

4. See, for example, the special issue of *Canadian Public Policy* devoted to Canada-United States trade and policy issues, edited by J. M. Curtis and A. R. Moroz. A handy overview is presented in R. S. Saunders, "Continentalism and Economic Nationalism in the Manufacturing Sector: Seeking Middle Ground", pp. 453-479 of this volume. The best modern statement against continentalism from a trade policy perspective can be found in M.G. Clark (1980), "Canada-United States Trade Relations".

5. In the speech referred to in note 3.

6. Exchange of letters between delegations towards the close of negotiations.

7. On 18 November 1983 at the Second Annual Workshop on US-Canadian Relations at the University of Western Ontario.

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Michael Hart

The government has announced its intention to study the advantages and disadvantages of limited free trade arrangements with the United States. This essay examines the policy considerations underlying this decision and the issues which must be addressed before any decision to negotiate is taken. The multilateral and bilateral dimensions of Canadian trade policy in developing a stronger domestic economy and promoting a stable and open international trading environment are explored. This study also traces the history of earlier efforts to improve access to the US market and examines in detail factors affecting trade liberalization for three sectors: urban transportation equipment, petrochemicals, and traded computer services.

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